Office of Chief Counsel
Internal Revenue Service

# memorandum

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BAKranzthor

date: March 7, 2002

to: Bonnie Barber, International Examiner

from: Area Counsel
(Communications, Technology, and Media: Oakland)

subject: [redacted]
**Form 1120, Taxable Year Ended (TYE) [redacted]**

You requested our consideration of the following question:

> What is the gross sales price for the sale [in TYE [redacted]] of the operating assets of [redacted] (subsidiary of [redacted])? There is a non-competition agreement for $[redacted] and a license agreement for $[redacted]. Should these amounts be included in the total gross sales price for the operating assets, or are they separate?

You also stated that the purpose for this question is to determine whether the taxpayer has established that it is entitled to a worthless stock deduction in the TYE [redacted].

In our opinion the taxpayer has not established that it is entitled to a worthless stock deduction in TYE [redacted]. Under these circumstances the purported value of the covenant not to compete should not be respected for tax purposes. Moreover, the taxpayer's estimate of "closure costs" should also be disregarded. We do not, however, have enough information to determine whether or not the licensing agreement should be respected.

**FACTS:**

The U.S. parent company, [redacted], claimed a worthless stock deduction of $[redacted] in its TYE [redacted], representing its investment in its [redacted] subsidiary, [redacted].[1] In support of its claimed deduction the taxpayer submitted an appraisal report prepared by [redacted] ([redacted]). The [redacted] report, dated [redacted], concluded that [redacted] was worthless as of [redacted] because its Total Liabilities of

[1] This comes close to the amount of common stock shown in an appraisal report prepared for the taxpayer by [redacted] ([redacted] = $[redacted], using [redacted] as the [redacted]-to-$ exchange rate as of [redacted]).

[redacted] exceeded by almost [redacted] the fair market value of its Total Assets, which [redacted] valued at [redacted]. In addition to various other adjustments to the values of assets and liabilities shown on the books of [redacted] as of [redacted], [redacted] added to its calculation of Total Liabilities [redacted] for "closure costs." The [redacted] report (p. [redacted]) describes this amount as "workforce related severance payable in the event the Company closed its operations at [redacted] and began an orderly liquidation of the physical assets." [redacted] also wrote down the book value of the assets of [redacted] from [redacted] to the [redacted] figure.[2] The [redacted] report adjusted intercompany accounts payable only slightly (from [redacted] to [redacted]).

By sales agreement dated [redacted], [redacted] certain operating assets to [redacted], a [redacted] subsidiary of a privately-held [redacted] company. The sales agreement assigned the following values to the assets:

| [redacted]1=$[redacted] $1=DM[redacted] | sales contract | |
|---|---|---|
| Assets | [redacted] | US$ |
| § 6 subpara. 3 (a) inventory | [redacted] | [redacted] |
| § 6 subpara. 3 (b) other assets and liabilities | [redacted] | [redacted] |
| § 6 subpara. 3 (c) name rights | [redacted] | [redacted] |
| real property | [redacted] | [redacted] |
| Sales contract total | [redacted] | [redacted] |
| Non-Competition Commitment | [redacted] | [redacted] |
| Licensing Agreement | [redacted] | [redacted] |
| Total consideration | [redacted] | [redacted] |

The sales agreement ([redacted]) provided that the purchaser and seller were aware that under [redacted] law all employment agreements seller has with the affected employees will [redacted] Under [redacted] law, apparently, the sale of all the operating assets of a business results in the [redacted]

The sale of these assets was disclosed in [redacted]s SEC Form 10-K for the TYE [redacted]. According to the Form 10-K, [redacted] retained a real property interest worth $[redacted] and cash and accounts receivables totaling $[redacted]. It also

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[2] The major components of the asset write-down were: (1) Goodwill reduced to [redacted] from [redacted]; and (2) Net fixed assets reduced by [redacted] to [redacted].

retained third party liabilities of $[redacted]. This third party liability figure is substantially less than the adjusted liability totals in the [redacted] report, as shown by the following table:

| Per [redacted] Report (amounts in [redacted] x 1,000) | | | | [redacted] FMV [redacted] converted to $ (x 1000) | $ values ( x 1000) per sales contract and SEC Form 10-K[3] |
|---|---|---|---|---|---|
| **Assets** | Book Values [redacted] | FMV Adjustments | FMV [redacted] | | |
| Cash and Accts receivable | [redacted] | | [redacted] | [redacted] | [redacted] |
| Inventory | [redacted] | | [redacted] | [redacted] | |
| Other current assets | [redacted] | [redacted] | [redacted] | [redacted] | |
| Goodwill | [redacted] | [redacted] | [redacted] | [redacted] | |
| Net fixed assets | [redacted] | [redacted] | [redacted] | [redacted] | |
| Other assets | [redacted] | [redacted] | [redacted] | [redacted] | |
| Sales proceeds | | | | | [redacted] |
| Retained real property interest | | | | | [redacted] |
| Covenant not to compete | | | | | [redacted] |
| **Total Assets** | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] |
| **Liabilities** | | | | | |
| Third party liabilities[4] | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] |
| Intercompany accts payable | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] |
| Closure costs | | [redacted] | [redacted] | [redacted] | [redacted] |
| **Total Liabilities** | [redacted] | [redacted] | [redacted] | [redacted] | [redacted] |

In addition to the [redacted] of "closure costs," the [redacted] report also adds to liabilities [redacted] for "transaction related costs" that [redacted] assumed will be incurred to complete the sale of the assets. Although it is not clear where this [redacted]

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[3] The SEC Form 10-K did not state the amount of [redacted]'s intercompany accounts payable. The intercompany accounts payable amount is taken from the [redacted] report. This is the only figure in this column not taken from the sales agreement or from the Form 10-K.

[4] This amount equals the total of the following separately-listed liabilities in the [redacted] report: Accounts payable; Accrued expenses; Taxes and notes payable; Current part of long-term debt; Long-term debt; and Other liabilities.

[redacted] shows up in the [redacted] report's adjusted balance sheet, it seems likely that it accounts for the total [redacted] increase in third party liabilities reflected in the table above. It also seems possible that [redacted] overestimated this amount, resulting in the difference between [redacted]'s third party liability total and the amount reported to the SEC in the Form 10-K. What conclusions can be drawn from these figures will be discussed below.

Although the sales agreement describes the assets sold as belonging to a "division" of [redacted], we understand the assets sold were actually owned by [redacted] or [redacted] subsidiaries of [redacted], and that as of [redacted] also owned all the stock of [redacted] sales subsidiaries. All of these entities (that is, [redacted] and all its subsidiaries) filed "check-the-box" elections for the TYE [redacted], electing to be disregarded entities for U.S. tax purposes.

We also understand that all of [redacted]'s subsidiaries actually liquidated, presumably during TYE [redacted], except for [redacted] of the sales subsidiaries, which continues to operate in [redacted] (as a disregarded entity, for U.S. tax purposes).

In addition to the sale of assets for stated amounts, purchaser and seller at the same time signed documents titled, "Non-Competition Agreement" (referred to in this memo by the usual U.S. terminology, covenant not to compete) and "Exclusive Distribution and Supplier Agreement." The covenant not to compete recites that in order to have the full benefit of the purchase of the operating assets, purchaser wants a covenant not to compete from [redacted] ([redacted]'s parent company's parent), and agrees to pay $[redacted] for such an agreement with a [redacted]-year term. The Exclusive Distribution and Supplier Agreement states that purchaser will pay the seller $[redacted] for the right to be the exclusive distributor of seller's "[redacted]." Also, the purchaser agreed to buy and seller agreed to sell such product in the minimum annual amount of $[redacted] during said [redacted]-year term.

**DISCUSSION:**

To establish the worthlessness of a security under I.R.C. § 165(g), the taxpayer must show that (1) the security had value at the beginning of the taxable year; (2) the stock's issuer was insolvent at the end of the taxable year; and (3) the stock's issuer has no reasonable prospect of future value (ordinarily established by an identifiable event, such as liquidation or receivership). Morton v. Commissioner, 38 B.T.A. 1270, 1278-1279 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940).

We have received no information regarding whether [redacted] was solvent (or had potential value) as of [redacted]. We assume it did.

To determine whether the taxpayer has established [redacted]'s insolvency as of [redacted], we must analyze the figures contained in the two shaded columns at the right side of the table set out on page 3, above. To simplify comparisons between the figures the taxpayer reported to the SEC on Form 10-K (U.S. $ amounts) with the figures in the [redacted] report ([redacted] amounts), both of these shaded columns are computed in U.S. dollars.

The [redacted] report concluded that the fair market value of the [redacted] assets was $[redacted] as of [redacted]. Less than one month later, these same assets were actually sold to a third party. The actual sale of the assets so close in time to the valuation date is the best evidence of fair market value. The actual sale was for an adjusted[5] price of only $[redacted] (if both the covenant not to compete and the licensing agreement are considered separately, as the taxpayer contends should be done). Adding the stated values of both the covenant and the license would bring the total consideration up to $[redacted] (fairly close to the [redacted] asset FMV of $[redacted]). While the [redacted] FMV is by itself some evidence that both the covenant and the license were truly part of the purchase price, we think the evidence at this time more strongly supports including in addition only the stated value of the covenant, resulting in the $[redacted] figure shown as Total Assets in the far right column, as discussed below.

Many court cases have considered whether a stated value for a covenant not to compete should be respected as part of a sale of assets.[6] Where it is one of the parties to an agreement that is trying to disavow the terms of the agreement, the courts consider what level of proof should be required to disavow one's own agreement.[7] Where the Commissioner challenges the covenant, however, courts analyze the substance of the transaction. The Tax Court has described this analysis as follows:

> The fact that a taxpayer has allocated a specific amount to a covenant not to compete is not controlling for tax purposes. Lemery v. Commissioner, 52 T.C. 367, 375 (1969), affd. per curiam, 451 F.2d 173 (9th Cir. 1971). In order for the form in which the parties have cast their transaction to be respected for tax purposes, the covenant not to compete must have some independent basis in fact or some arguable relationship with business reality such that reasonable

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[5] In order to compare apples with apples, we have added to the sales proceeds the values the taxpayer put on assets that were included in the [redacted] valuation but which were not sold (i.e., cash and accounts receivable and the retained real property interest).

[6] The context of these cases is typically the attempt by either the Commissioner or one of the parties to a contract to either enforce or disregard the terms of the contract, with the underlying dispute usually involving ordinary versus capital gain. While the context of this case differs, we think the same principles apply to determine whether the covenant should be respected.

[7] See, e.g., Commissioner v. Danielson, 378 F.2d 771 (3d Cir. 1967), cert. denied 389 U.S. 858 (1967).

men, genuinely concerned with their economic future, might bargain for such an agreement. Schulz v. Commissioner, 294 F.2d 52, 55 (9th Cir. 1961), affg. 34 T.C. 235 (1960). This test is commonly referred to as the "economic reality" test. See Patterson v. Commissioner, 810 F.2d 562, 571 (6th Cir. 1987), affg. T.C. Memo. 1985-53. An allocation to a covenant not to compete lacks economic reality where there is no showing that the seller would experience a loss comparable to the amount supposedly paid for the covenant such that it would bargain for substitute compensation in that amount or that the buyer would lose such an amount were the seller to compete against it. See Forward Communications Corp. v. United States, 221 Ct. Cl. 582, 608 F.2d at 493-494.

Buckley v. Commissioner, T.C. Memo. 1994-470, 68 T.C.M. (CCH) 754, 769 (1994). In the Buckley case, the Tax Court determined that a covenant not to compete was entitled to no value. The parties had set the value of the covenant at $1.9 million, but the Tax Court found that figure to lack economic reality where the seller wished to divest itself of the property (a radio station) and would be prohibited by Federal Communications Commission rules from re-entering the market unless it first sold other media property.[8] In this case [redacted] was not legally prohibited from competing with the purchaser, but the circumstances of the sale make clear that [redacted]'s sole objective was to get out of that business in [redacted]. [redacted] plainly suffered no loss from being prohibited from competing with the buyer, and similarly the buyer had nothing to lose by allowing the seller to compete. Furthermore, valuing a covenant not to compete at $[redacted] is fundamentally inconsistent with maintaining that one's business has no potential value. The taxpayer's claim that the [redacted] business had no potential value as of [redacted] should be evaluated by assigning a zero value to the covenant; therefore, the $[redacted] stated value of the covenant should be included instead in the value of the [redacted] GmbH assets.

We do not think the same analysis applies to the license agreement. We do not know whether being the exclusive distributor of OCLI's "[redacted]" plus guaranteeing a supply of it for [redacted] years was truly worth $[redacted] to the buyer, but at least it could be without flatly contradicting the taxpayer's claim that the [redacted]'s business was worthless. Perhaps the engineer agent can shed some light on this question.

Turning now to the liability side of the ledger, we see no basis for adding $[redacted] to [redacted]'s liabilities for "closure costs." Although we do not know exactly when negotiations began between buyer and seller, the sales agreement was dated [redacted], only [redacted] days after the close of the [redacted] taxable year. We find it inconceivable that as of [redacted] believed that it would have to sell the assets of [redacted] on a piecemeal basis, thus incurring substantial liabilities under [redacted] law. Under these facts [redacted] must have already been in contact with the seller, and must have intended

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[8] The Tax Court also found, under different facts, that a second covenant did have value, though much less than the contract stated.

to sell substantially all the operating assets of [redacted] to one buyer. Under that assumption, [redacted] had no liability for "closure costs" under [redacted] law because the employees were transferred to the buyer under operation of [redacted] law (as acknowledged in the sales agreement). Therefore, the far right column puts the [redacted] liability for closure costs at [redacted].

The remaining possible liabilities are third party liabilities and intercompany liabilities. For third party liabilities we took the figure disclosed in the Form 10-K, $[redacted]. We regard that figure as more accurate than the $[redacted] shown in the [redacted] report because the [redacted] figure seems to include estimates of "transaction related costs" of liquidating the [redacted] assets that never happened. The last liability figure, intercompany liabilities, was not disclosed in the Form 10-K, so we have used the [redacted] figure of $[redacted] in our computation.[9]

Turning now to a comparison of Total Assets against Total Liabilities, we find the [redacted] report's conclusion to be completely unpersuasive. Liabilities exceed assets only because: (1) [redacted] fails to include the $[redacted] amount improperly assigned to the covenant; (2) [redacted] includes without justification "closure costs" of $[redacted] as a liability; and (3) the taxpayer has not established that intercompany liabilities should be counted in any amount. By taking the values disclosed by the taxpayer in the SEC Form 10-K, including the $[redacted] from the covenant, and by eliminating the "closure costs," we believe [redacted]'s assets exceeded its liabilities as of [redacted], even if intercompany liabilities in the amount stated by [redacted] are counted.

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[9] This figure is accepted for illustrative purposes only, since under some circumstances we might argue that all intercompany liabilities should be treated as equity, not as liabilities at all. We would need to know when the intercompany liabilities arose, whether formal documents evidence these liabilities, etc. See Flint Industries v. Commissioner, T.C. Memo. 2001-276. We understand the taxpayer has not provided the information needed to make this sort of analysis.

Since we believe [redacted] has not established that [redacted] was insolvent as of [redacted], we do not consider whether the [redacted] business had potential value as of [redacted]. Therefore, we do not consider whether the "check-the-box" election can serve as an "identifiable event" for purposes of section 165(g).

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By:______________________
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